Volume 85 | Issue 1 Article 10

September 1982

The Bad Blood Factor and 302 Redemptions: A Retrospective Examination and Analysis

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THE 'BAD BLOOD FACTOR' AND § 302 REDEMPTIONS: A RETROSPECTIVE EXAMINATION AND ANALYSIS

INTRODUCTION

Open hostility among family members who are also shareholders in a closely held corporation can have a devastating effect on the health and prosperity of that corporation. Frequently, the best remedy, once reconciliation proves impossible, is a rapid and complete withdrawal of one of the hostile factions. The withdrawing party might sell his shares to an unrelated individual, but finding a ready buyer may be difficult. Fellow shareholders may be unwilling or unable to purchase the available shares. Moreover, closely held corporations are not given to welcoming unrelated, unknown, potential shareholders. As a result, the only satisfactory means of terminating the interest is often for the corporation to redeem the stock itself.

The taxpayer who receives money or other property from the redemption of his stock will usually prefer to report the transaction to the Internal Revenue Service as a sale or exchange so he can take advantage of capital gains deductions attendant such a classification.[1] But in order to qualify for the favorable treatment, the redemption must not be "essentially equivalent to a dividend," must be substantially disproportionate with respect to the shareholder, or must result in a complete termination of the shareholder's interest in the corporation. If the redemption does not meet one of these three conditions, it will be treated as a distribution of property which is subject to taxation in full and at ordinary rates as a dividend.[2] The shareholder who redeems his stock because of "bad blood" between himself and related shareholders may find that meeting these conditions is more difficult because of attribution rules. These rules give him constructive ownership of stock directly owned by those hostile, related shareholders and appear to be grounded on an assumption of unity between related attributees.[3] This note explores the varying success taxpayers have achieved attempting to obtain recognition of the "bad blood" factor in redemptions motivated by hostility. It presents the statutory, legislative, and judicial history of the law in this area and critically analyzes its current status.

I. ATTRIBUTION RULES OF I.R.C. § 318

Any shareholder who seeks to terminate his interest in a corporation by having the corporation redeem his stock must consider the effect of the attribution rules of § 318 on his ownership status. Under those rules a person is

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[1] *See* I.R.C. § 1202 (1976 and Supp. IV 1980). All references in the text and footnotes are to the Internal Revenue Code of 1954 [hereinafter sometimes referred to as the Code] as it appears in 26 U.S.C. (1976) unless otherwise noted.

[2] *See* I.R.C. § 302 (1976 and Supp. IV 1980). *See also infra*, text accompanying notes 14-25.

[3] *See* I.R.C. § 318 (1976). *See also infra*, text accompanying notes 4-13.

considered to constructively own stock held by his spouse,[4] children, grandchildren, and parents.[5] Similarly, stock actually owned by a partner, a beneficiary of an estate,[6] or a trust[7] is considered to be constructively owned by the partnership, the estate, or the trust itself. The rules also attribute stock ownership from shareholders to corporations if the shareholder owns fifty percent or more in value of the stock.[8] Attribution applies in both directions. For example, stock owned by a partnership, corporation, trust or estate is owned constructively and proportionately by its partners, shareholders, or beneficiaries.[9]

Once § 318 attributes stock from one person or entity to another, the Internal Revenue Code provides for its reattribution in accordance with the rules described above.[10] For example, corporate stock owned by a trust might be attributed to the trust's beneficiary and then attributed again to the beneficiary's son. The result is that the son constructively owns corporate stock through reattribution. Two limitations confine reattribution. Stock attributed from one family member to another cannot be reattributed to a third family member;[11] and stock attributed to a partnership, estate, trust, or corporation by partners, beneficiaries, or shareholders cannot be reattributed from the entities to other partners, beneficiaries, or shareholders.[12]

The attribution rules have been referred to as "horror stories"[13] for shareholders who wish to completely terminate their interests in a corporation. Although the shareholder sells all the stock he owns directly, he cannot easily rid himself of stock he owns constructively through attribution. The attribution rules appear to be based on the assumption that individuals and entities which are closely related will act in harmony with each other's interests. The effect hostility between attributees has on this assumption and, hence, on constructive ownership of stock is a key issue explored here.

II. Stock Redemptions and the Internal Revenue Code

A. *Section 302*

The Internal Revenue Code provides that "stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property. . . ."[14] Once the Code classifies the transaction as a redemption, § 302 determines how the redemption should be reported.

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[4] I.R.C. § 318(a)(1)(A)(i) (1976).
[5] I.R.C. § 318(a)(1)(A)(ii) (1976).
[6] I.R.C. § 318(a)(3)(A) (1976).
[7] I.R.C. § 318(a)(3)(B) (1976).
[8] I.R.C. § 318(a)(3)(C) (1976).
[9] I.R.C. § 318(a)(2)(A)-(C) (1976).
[10] I.R.C. § 318(a)(5)(A) (1976).
[11] I.R.C. § 318(a)(5)(B) (1976).
[12] I.R.C. § 318(a)(5)(C) (1976).
[13] Rickey v. United States, 592 F.2d 1251, 1255 n.4 (5th Cir. 1979), *reh. denied*, 599 F.2d 1054 (1979).
[14] I.R.C. § 317(b) (1976). "Property" includes money. I.R.C. § 317(a) (1976).

Section 302(a) provides that "such redemption shall be treated as a distribution in part or full payment in exchange for the stock." Exchange treatment qualifies the transaction for a possible capital gains deduction, a favorable treatment since sixty percent of net capital gain can be deducted from ordinary income.[15] But exchange treatment is made available only if the redemption meets one of the conditions set out in §§ 302(b)(1), (2), and (3). If the redemption does not meet one of these conditions, § 302(d) provides that the distribution will receive less favorable treatment, possibly as a dividend. Dividend treatment, outlined elsewhere in the Code,[16] could result in ordinary income which is taxable in full.

The first of the § 302 conditions, or "safe harbors," is that the redemption must not be "essentially equivalent to a dividend."[17] The second "safe harbor" permits exchange treatment "if the distribution is substantially disproportionate with respect to the shareholder."[18] The assumption is that since dividends are characteristically pro-rata distributions, a substantially disproportionate distribution in a redemption is less likely to arise from dividend motivation. The Code defines "substantially disproportionate" in terms of a comparison between the percentage of voting stock the shareholder owns before the redemption and the percentage he owns after the redemption. In order to qualify for exchange treatment, the stockholder, after the redemption has taken place, must own less than eighty percent of the percentage of voting stock he owned before the redemption.[19] This second safe harbor contains two limitations in addition to the requirement of a substantially disproportionate distribution. First, after the redemption, the shareholder must "own less than 50% of the total combined voting power of all classes of stock entitled to vote."[20] Second, the section denies exchange treatment to distributions which, though apparently disproportionate when viewed separately, are made in pursuance of a plan, the total effect of which results in a distribution which is not substantially disproportionate.[21] Redemptions which represent a complete termination of the shareholder's interest in the corporation fall into the third safe harbor and are given sale or exchange treatment.[22] The Code also makes clear that the test of dividend equivalency found in the first "safe harbor" rule will determine the issue, despite the failure of the redemption to meet the substantially disproportionate redemption test or the termination of shareholder interest test.[23]

Whether a redemption falls under the protection of one of the "safe

[15] I.R.C. § 1202(a) (1976 and Supp. IV 1980).
[16] I.R.C. § 301 (1976).
[17] I.R.C. § 302(b)(1) (1976).
[18] I.R.C. § 302(b)(2) (1976).
[19] I.R.C. § 302(b)(2)(C) (1976).
[20] I.R.C. § 302(b)(2)(B) (1976).
[21] I.R.C. § 302(b)(2)(D) (1976).
[22] I.R.C. § 302(b)(3) (1976). A fourth safe harbor applied exclusively to redemptions of stock issued by a railroad corporation under a plan of reorganization. I.R.C. § 302(b)(4) (1976). This provision was eliminated by the Bankruptcy Act of 1980 and is not pertinent here.
[23] I.R.C. § 302(b)(4) (Supp. IV 1980).

harbors" depends both on the stock the shareholder owns directly and on the shares he constructively owns under the attribution rules of § 318(a).[24] But forced constructive ownership of stock through the attribution process can be costly to the taxpayer who, because of attribution, loses capital gains deductions. The burden occasioned by stock attribution when stock redemptions arise out of family hostility forms the core of the family hostility problem.

B. *History of the § 302 Conditions*

Commentators agree that *Eisner v. Macomber*[25] was probably the stimulus for the language of the condition found in § 302(b)(1).[26] The Court held in *Eisner* that dividends in the form of additional stock could not be taxed as income to the taxpayer.[27] The Court reasoned that, although gain derived *from* capital was income, a stock dividend was essentially a transfer of an accumulated surplus *to* the capital account of a corporation. The Court held a tax on such a capital increase was void because the tax would run afoul of the sixteenth amendment requirement that direct taxes be apportioned according to the population.[28]

A loophole formed after the *Eisner* decision. A corporation might lessen the tax impact of a proposed shareholder dividend by first issuing a stock dividend, not taxable under *Eisner*, and then immediately redeeming the just issued stock for cash. The shareholder would have all the original benefits of a stock redemption, including exchange and capital gains treatment, even though the purpose of the transaction was to put a cash dividend in his hands.

Congress enacted § 201(d) of the Revenue Act of 1921 to close the loophole. It provided:

> A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption *essentially equivalent to the distribution of a taxable dividend*, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings and profits accumulated by such corporation after February 28, 1913. (emphasis added)[29]

Through judicial expansion, § 115(g) of the 1939 Code, which codified §

[24] I.R.C. § 302(c)(1) (1976).

[25] 252 U.S. 189 (1920).

[26] *See, e.g.*, BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.02 (4th ed. 1979) [hereinafter cited as BITTKER & EUSTICE].

[27] 252 U.S. at 219.

[28] *Id.*

[29] Revenue Act of 1921, ch. 136, 42 Stat. 228 (codified as amended at I.R.C. § 115(g) (1939)). I.R.C. 115(g) (1939) provided:

> If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such a time and in such a manner as to make the distribution and cancellation or redemption in whole or in part *essentially equivalent to the distribution of a taxable dividend*, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings and profits accumulated after February 28, 1913, shall be treated as a taxable dividend. (emphasis added)

201(d), eventually came to mean that courts would view any pro-rata redemption with suspicion. The taxpayer would have the burden of showing that the redemption was not essentially equivalent to a dividend but should instead be treated as a sale or exchange.[30]

The actual determination of dividend equivalency was based on all the material circumstances surrounding the redemption. In *Boyle v. Commissioner*[31] the court noted several circumstances which led it to decide the dividend equivalency question: (1) the redeeming corporation never paid cash dividends, though it had accumulated a large, unnecessary surplus of cash; (2) no evidence showed that the corporation was pursuing any policy of contraction or liquidation; and (3) the initiative for the distribution came from the majority shareholder.[32]

Cases such as *Boyle* clearly showed dividend equivalency to be a question of fact. Courts would review a wide variety of circumstances to make that factual determination.[33] In one case, for example, a court permitted a jury to weigh evidence of family hostility. Certain family members wanted to avoid having stock fall into the hands of another family member whose voice was not welcomed in the corporation.[34]

Before the passage of the Internal Revenue Code of 1954,[35] Congress saw a need to assist courts in making the determination of whether a stock redemption was essentially equivalent to a dividend. It added the more mechanical safe harbor provisions found in §§ 302(b)(2), (3). When the House Ways and Means Committee reported out the bill which included those mechanical conditions,[36] the Committee noted that prior to the 1954 Act considerable confusion attended the determination of when a stock redemption would result in capital gain and when it would result in ordinary income. The report indicated that taxpayers had been "faced with potential dividend-tax liability in many cases where such result [was] unwarranted, and in other cases [had] avoided such liability where the redemption was the equivalent of a dividend."[37]

The Committee reported further that the attribution rules, which resulted in a shareholder owning stock held by his immediate family, were designed to prevent tax evasion. The Committee wrote:

> At the present time a possible opportunity for tax avoidance results when re-

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[30] *See* BITTKER & EUSTICE, *supra* note 26.

[31] 187 F.2d 557, 560-61 (3d Cir.), *cert. denied*, 342 U.S. 817 (1951).

[32] *See also, e.g.*, Comm'r v. Roberts, 203 F.2d 304 (4th Cir. 1953). (In *Roberts* the court reviewed the circumstances surrounding a redemption of shares bequeathed to the taxpayer by his brother, the critical circumstance being that the taxpayer's relationship to the corporation was not changed by the redemption. He continued as sole shareholder after the redemption.).

[33] *But see* Northup v. United States, 240 F.2d 304, 307 (2d Cir. 1957) (issue of essential equivalence to a dividend found to be a question of law rather than one of fact). *Cf.* Metzger Trust v. Comm'r, 76 T.C. 42 (1981), *appeal filed*, (August 14, 1981).

[34] Jones v. Griffin, 216 F.2d 885, 890 (10th Cir. 1954).

[35] Pub. L. No. 591-736, 68A Stat. 1.

[36] *See generally* H.R. REP. No. 1337, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4058 (legislative history of the Act).

[37] *Id.* at 4060.

demptions are effected in the case of family-owned corporations. To prevent tax avoidance, but at the same time to provide *definitive rules* for the guidance of taxpayers, your committee has provided *precise standards* whereby under specific circumstances, a shareholder may be considered as owning stock held by members of his immediate family (or by partnerships, corporations, or trusts which he controls). (emphasis added).[38]

The bill reported out by the Committee[39] did not include the old § 115(g) test of whether the redemption was essentially equivalent to a dividend.[40] Apparently, the members thought the test too broad and too difficult to apply as evidenced by their recommendation of definitive rules and precise standards. A superficial reliance on this report alone might lead the Internal Revenue Service to ignore any collateral factors, which would blunt the precision with which it could classify § 302 redemptions.[41] However, when the Senate Finance Committee reported the bill out, it reinserted the essence of the § 115(g) language—language which remains today as § 302(b)(1). To the Senate Committee, the House provision "appeared *unnecessarily restrictive*, particularly in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption took place."[42]

What appeared to be black and white in the Ways and Means Committee's approach suddenly appeared gray after the Senate Finance Committee reported. The report gave its readers an example where the restrictive rules would produce inequitable results. The example did not include family hostility but concerned a corporation which called its stock without the input of the preferred shareholder.[43] Whether one may broadly interpret the report as meaning, that § 302(b)(1) stands available as a palliative measure whenever the mechanical rules do not produce equitable results, is arguable.

Congress may have intended, through the reinsertion of § 302(b)(1), to give effect to the notion of flexibility, prompting a later court to comment: "Complex as today's tax laws have become, we are convinced Congress intended and desired enforcement proceedings to be accompanied by common sense and basic principles of fairness."[44]

Some evidence, at least, suggests the Senate Finance Committee intended the results of the § 302(b)(1) test to take priority over whatever result was obtained from application of the other tests in the section. It referred to the § 302(b)(1) "dividend equivalency test" as the "general rule," to be "supplemented" by the "substantially disproportionate" test. The inquiry, when ap-

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[38] *Id.* at 4061.

[39] H.R. 8300, 83d CONG. REC., 2d Sess., (1954).

[40] *See supra* note 30 and accompanying text.

[41] *See* Note, *Family Hostility as a Factor in Determining Constructive Stock Ownership in Corporate Redemptions*, 29 TAX LAW. 386, 392-93 (1976).

[42] S. REP. No. 1622, 83d CONG. REC., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4675.

[43] *Id.*

[44] Rickey v. United States, 592 F.2d 1251, 1258 (5th Cir. 1979), *reh. denied*, 599 F.2d 1054 (1979).

plying the "dividend equivalency" test, "will be devoted solely to the question of whether or not the transaction by its nature may be properly characterized as a sale of stock by the redeeming shareholder to the corporation."[45]

C. *Treasury Regulation*

The regulations the Treasury issued to implement § 302 and to offer guidelines for its application give the courts significant discretion to decide dividend equivalency despite the available mechanical tests. The regulations state that the question of dividend equivalency for a redemption "depends on the facts and circumstances of each case."[46] They also imply that a number of facts should be considered in making the determination, only one of which is attribution: "*One* of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under § 318(a)."[47]

III. The Early Recognition of Family Hostility

Estate of Squier v. Commissioner[48] is the first case where the bad blood factor was clearly recognized in the context of § 302 redemption of stock, and it serves to illustrate the basic issue.

In this case, three individuals and a trust owned various proportions of a small corporation. The principal shareholder, Squier, died, and a rift quickly developed between his shareholder wife and the banker controlling her husband's estate. Three years after Squier died, the estate redeemed a significant portion of its shares. The purposes of the redemption were to raise money to satisfy inheritance and federal estate tax liabilities, and to meet some of the estate's outstanding debts.[49] The redemption reduced the estate's proportionate share of corporate ownership from 50.09% to 41.27%.[50] Although, after the transaction, the estated owned only 1,720 shares directly, its stock ownership could increase to 2,368 shares if the attribution rules applied. Section 302(c)(1) leads one to the conclusion that the rules should apply.[51]

The Tax Court, however, without even discussing attribution, agreed with the estate that the entire redemption of stock should be given exchange treatment. The court recognized the "sharp cleavage between the executor and

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[45] S. Rep. No. 1622, *supra* note 42, at 4870-71. The sale of a withdrawing shareholder's stock to the most readily available buyer, the corporation, when the shareholder needs to rapidly divest himself of his holdings because of family discord seems to fall easily within the Committee's inquiry.

[46] Treas. Reg. § 1.302-2(b) (1956).

[47] *Id.*

[48] 35 T.C. 950 (1961), *acq.* 1961-2 C.B. 5, *acq. withdrawn and nonacq. substituted*, 1978-2 C.B. 5.

[49] I.R.C. § 303 (1954) permits the redemption of shares to pay death taxes and funeral administration expenses. The transaction is treated like a sale and, therefore, qualifies for the favorable capital gains treatment. In *Squier*, the money distributed in the redemption to cover debts of the estate would not fall under the protection of the death taxes exception in the code.

[50] 35 T.C. at 950, 952.

[51] I.R.C. § 302(c)(1) (1954) provides in pertinent part that the attribution rules "shall apply in determining the ownership of stock for purposes of this section."

members of the Squier family" which resulted in a "crucial reduction of the estate's *control* over the corporation."[52] But the Tax Court did not decide the issue on the sharp cleavage alone. It also gave weight to the existence of a significant minority interest in the corporation: an interest not affected by attribution.[53] The minority interest prevented the estate from being considered the sole owner of the corporation's outstanding shares. The Court distinguished its decision from its holding in *Lewis*, a case it decided the year before.[54] There, the court held the questioned redemption to be taxable as a dividend, but, in that case, the estate would have been treated, after the application of the attribution rules, as the sole owner of the outstanding stock of the corporation. In *Squier*, the substantial minority interest prevented that result. In any event, the critical factor for the court appeared to be how much actual control the estate could exercise after the redemption of its shares, not how much presumed control the estate could exercise after a mechanical attribution of stock ownership.

The Tax Court soon decided another case under the *Squier* reasoning. *Parker v. Commissioner* concerned a redemption that shifted control of a corporation from father to son.[55] The father and son severely disagreed over the management of the company, and they saw the shift in control as a way of resolving the problem. Although after the redemption the father maintained control of the corporation on paper through constructive ownership of his son's stock, the court was persuaded by the total factual picture that the redemption of stock was not equivalent to a dividend.[56]

Parker is significant in that the court permitted exchange treatment even absent the substantial, unrelated minority interest as found in *Squier*. Although the court conceded the absence of such an interest weakened the case as compared with *Squier*, the "sharp and continuing disagreement" between Parker and his son sufficed to negate control.[57] The bad blood factor had gained ground.

The flexible interpretation the Tax Court accorded § 302(b)(1) in *Squier* and *Parker* did not provoke taxpayers to rush to the courts claiming that family hostility motivated their stock redemptions. Case reports did show that dividend equivalency was being decided on a case by case basis,[58] but none of these decisions concerned the effect of family hostility on redemptions as a central issue until *Haft Trust v. Commissioner* was decided in 1973. [59]

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[52] 35 T.C. at 955-56 (emphasis in original).

[53] *Id.* at 956.

[54] Lewis v. Comm'r, 35 T.C. 71 (1960) (There were no hostile interests or adversity of interests among the various shareholders in this case.).

[55] 20 T.C.M. (CCH) 893 (1961).

[56] *Id.* at 901.

[57] *Id.*

[58] *See, e.g.*, Bains v. United States, 289 F.2d 644, 646 (1961) (decided "on basis of the particular facts in question").

[59] Haft Trust v. Comm'r, 61 T.C. 398 (1973), *supplemental opinion*, 62 T.C. 145 (1974), *vacated and remanded*, 510 F.2d 43 (1st Cir. 1975). *See infra* text accompanying notes 70-79.

Another court showed its receptivity to the bad blood factor in *Bradbury v. Commissioner*, although family hostility was not the issue in the case.[60] The First Circuit Court of Appeals remarked that "[w]hile [the] attribution rules are generally applicable to § 302(b)(1) . . . their imposition is not inflexible and if it can be demonstrated that discord exists in a family relationship which would make attribution unwarranted, they will not be applied."[61] While the law emerging from the case-by-case approach seemed flexible enough to admit bad blood as a factor to be considered, that very flexibility was proving troublesome to some courts. The Fourth Circuit, with evident exasperation, in one case referred to the "morass created by the decisions."[62]

IV. *Davis* Provokes a Reconsideration

The Supreme Court decided *United States v. Davis* in 1970.[63] This important case precipitated a change in the thinking of both the Tax Court and the Internal Revenue Service with regard to the ability of § 302(b)(1) to embrace the bad blood factor. *Davis* contained elements which would seemingly support both sides of the question. Though the facts do not evidence family hostility, the holding of the case is important to the validity of mechanically applying the attribution rules, however harsh their ultimate result.

Four members of the Maclin P. Davis family owned the corporation at the time of the redemption. Davis himself owned 250 shares of common stock, as did his wife, his son, and his daughter. Shortly after the corporation was formed, Davis received 1,000 shares of preferred stock in return for an additional $25,000 investment. The additional investment was a necessary addition to capital required for the corporation to qualify for a loan. The directors agreed from the start that after the loan was repaid the corporation would redeem Davis' 1,000 shares of preferred stock, returning to him the precise amount of his additional investment. The corporation repaid the loan, redeemed the shares, and Davis reported the $25,000 he received in the redemption as having been received from a sale or exchange. By Davis' reckoning, he had no income to report since he realized no gain from the redemption, his basis in the stock also being $25,000. The Internal Revenue Service argued, on the other hand, that the redemption of Davis' preferred stock was essentially equivalent to a dividend within the meaning of § 302(b)(1) and should, therefore, be treated as a dividend under §§ 301 and 316.[64]

The Supreme Court approved the dividend treatment. According to the Court, the attribution rules were to be applied to all of § 302, including the determination of dividend equivalence in § 302(b)(1).[65] Attribution in this case rendered Davis a sole shareholder before and after the redemption. The Court

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[60] 298 F.2d 111 (1st Cir. 1962).

[61] *Id.* at 116 n.7.

[62] Ballenger v. United States, 301 F.2d 192, 196 (4th Cir. 1962).

[63] 397 U.S. 301, *reh'g denied*, 397 U.S. 1071 (1970).

[64] I.R.C. § 301(c)(1) (1954) provides that a distribution by a corporation with respect to its stock which is a dividend shall be included in gross income. I.R.C. § 316 defines "dividend".

[65] *Davis*, 397 U.S. at 306.

considered him, as a sole shareholder, to have simply redeemed a portion of his stock and held that "such a redemption is always 'essentially equivalent to a dividend.' "[66]

The Court decided that whether the corporation had a valid business purpose for making the redemption was an irrelevant issue in the determination of dividend equivalence.[67] The Court held that "to qualify for preferential treatment [under § 302(b)(1)], a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation" after the application of the attribution rules.[68] The statement appeared flexible enough to support the assertion that even after attribution, if family hostility results in a "meaningful reduction" of interest in the corporation, exchange treatment could follow. The Second Circuit defined interest in the corporation as including the right to vote and "thereby exercise control."[69] *Davis* was not dispositive of whether family hostility could soften the application of the attribution rules because the issue was not presented there.

When the issue of family hostility and the effect of the attribution rules did finally arise again before the Tax Court in *Haft Trust v. Commissioner*, the majority interpreted *Davis* as rejecting the rationale on which the *Squier* case was decided.[70] On facts fraught with family hostility, the court decided not to give consideration to the bad blood factor. The taxpayer appealed the determination to the First Circuit which vacated the Tax Court's decision.

The Tax Court had held that the plain language of § 302 made the attribution rules apply. Furthermore, it claimed recognition of family hostility would frustrate legislative objectives and be inconsistent with *Davis*.[71] In vacating the Tax Court decision, the First Circuit relied on *Squier* for the proposition that "family discord could belie the community of interest rationale of the attribution rules."[72] That court construed *Davis* as not requiring that the factual inquiry end after taking into account the attribution rules[73] and further supported its position by pointing to the regulations' implication that attribution is only one factor to be considered in making determinations of dividend equivalency.[74]

Emphasizing the congressional reinsertion of the "essentially equivalent" language in § 302(b)(1), the court concluded:

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[66] *Id.* at 307.

[67] *Id.* at 312. *See also* Hasbrook v. United States, 343 F.2d 811, 814 (2d Cir.), *cert. denied*, 382 U.S. 834 (1965). The business purpose deemed irrelevant was that of utilizing the corporation's high credit rating in order to indirectly obtain a loan for another corporation.

[68] *Davis*, 397 U.S. at 313.

[69] Himmel v. Comm'r, 338 F.2d 815, 817 (2d Cir. 1964). The taxpayer would seem free to argue that because of family hostility he had no control despite the presumed "attribution" of control through the operation of § 318.

[70] *Haft Trust*, 61 T.C. at 403.

[71] *Id.*

[72] *Haft Trust*, 510 F.2d at 46.

[73] *Id.* at 47.

[74] *Id.*

> [T]hough a wooden subjugation to the attribution rules might have administrative advantages it could also work injustice in particular cases, and we think that in retaining this section [302(b)(1)] in the Code alongside the safe harbor rules, Congress showed itself willing to tolerate some administrative inconvenience for the sake of taxpayer equity.[75]

Not finding enough information in the record to make its own decision on the full effects of family hostility in this particular instance, the court remanded the case. However, a subsequent settlement obviated the necessity for another Tax Court review.[76]

V. Responses to *Davis* and *Haft*

The Internal Revenue Service was not impressed with the First Circuit's reasoning. The Commissioner considered facts similar to those found in *Haft* in a revenue ruling and declared that the Service would not follow the First Circuit's decision.[77] He weighed the easily applied objective standards for stock attribution and determination of control with what he regarded as "the confusion of prior law" and opted in favor of the former.[78] In 1978 the Service withdrew its acquiescence to the Tax Court's flexible approach in *Squier*.[79]

Some commentators suggest that in its revenue ruling the Service was bucking the rising tide of jurisdictions which favored the recognition of bad blood as a mitigator of the effects of the attribution rules.[80] Those jurisdictions included both the Eighth and Ninth Circuits which seemed to lean toward the First in potentially recognizing the bad blood factor. The cases considered by the Eighth and Ninth Circuits did not deal with the same family hostility factual pattern, but the tilt towards the First Circuit's approach is observable.

In the Eighth Circuit case of *Wright v. United States*,[81] Judge Bright hypothesized that had the case involved shares attributed to the taxpayer through shareholders "with interests adverse to the taxpayer" then the *Squier* case would be applicable, i.e., family hostility would be considered in determining dividend equivalency.[82]

The Ninth Circuit case, *Title Insurance & Trust Co. v. United States*,[83]

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[75] *Id.* at 48.

[76] *See*, Note, *Family Hostility as a Factor in Determining Constructive Stock Ownership*, *supra* note 58, at 392.

[77] Rev. Rul. 80-26, 1980-1 C.B. 66, ("The facts and circumstances of a particular case cannot contradict the mechanical determination under section 318 of how much stock a shareholder owns." *Id.* at 67.).

[78] *Id.*

[79] 1978-2 C.B. 5.

[80] *See, e.g.*, O'Dell & Boyd, *Family Hostility and Stock Redemption: RR 80-26 Revives the Controversy*, 59 Taxes 153 (1981). *See also* Swennes, *"Not essentially equivalent to a dividend" Exception Still Viable Despite Davis*, 41 J. Tax'n 78 (1974). Courts since *Davis* have taken a "pragmatic approach to the meaningful reduction issue and have eschewed adopting any formalized test." *Id.* at 83.

[81] 482 F.2d 600 (8th Cir. 1973) (Bright, J., dissenting).

[82] *Id.* at 612.

[83] 484 F.2d 462 (9th Cir. 1973).

concerned facts similar to *Haft* and Rev. Rul. 80-26, except that the essential family hostility ingredient was lacking. Husband and wife, sole owners of a corporation, had created three trusts, one for each of their three children, to share in the corporate ownership. For what they considered to be valid business reasons (not hostility related), the husband and wife caused the corporation to completely redeem the stock owned by the trusts. Despite the complete termination of actual interest caused by the redemption, the court still considered each trust to be a 100% shareholder because of attribution from the parents by way of the children. The distribution was held to be essentially equivalent to a dividend, but the court, referring to the assumption of unity and entity in a family, said, "[s]uch assumptions may, indeed, prove awkward or unfair in cases where families do not behave as the rules assume they will, and intra-family disputes exist as to who should control and how."[84]

The Fifth Circuit also appears to stand ready to broaden the recognition given to the effects of bad blood. The court in *Rickey v. United States*[85] did not construe § 302(b)(1), yet it seemed to nod approval to the First Circuit's decision in *Haft* to follow *Squier*. "It can be argued that *Squier* was overruled *sub silentio* by the Supreme Court's decision in *United States v. Davis*. . . . We do not agree with that interpretation as *Davis* involved no claim of family hostility."[86] How the Fifth Circuit dealt with *Rickey* is especially important because the most recent case involving family hostility has been appealed to that forum.[87]

The Tax Court has shown some ambivalence in recognizing family hostility in the § 302(b)(1) dividend equivalency determination. On the one hand, in a note to *Deyoe v. Commissioner*, the Tax Court referred to the words "essentially equivalent to a dividend" and opined that they were words "which Congress clearly intended to receive judicial elaboration."[88] In a 1979 case, the Tax Court did not summarily dismiss the taxpayer's claim of family hostility but reviewed the facts closely, taking into consideration evidence of *friendly* relations between the pertinent individuals.[89] The court did not find hostility on the facts of the case, but at least showed a willingness to consider the factor.[90] In an earlier case, the Tax Court emphasized the full applicability of the effects of attribution in every case as a means of "remov[ing] the uncertainties existing under prior law."[91] Control of the corporation was determined "notwithstanding any 'bad blood'."[92] But even in this case the Tax Court reviewed the facts closely enough to disagree with the taxpayer about the existence of

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[84] *Id.* at 465 n.4.

[85] 592 F.2d 1251 (5th Cir. 1979).

[86] *Id.* at 1257 n.6.

[87] *See* Metzger Trust v. Comm'r, 76 T.C. 42 (1981), *appeal filed*, Aug. 14, 1981.

[88] 66 T.C. 904, 915 n.6 (1976).

[89] Johnson Trust v. Comm'r, 71 T.C. 941, 946 (1979).

[90] The *Johnson* court nevertheless found the attribution rules inapplicable because the redemption was complete, and the redeemed trust filed the requisite § 302(c)(2)(iii) waiver agreement. *Id.* at 955.

[91] Niedermeyer v. Comm'r, 62 T.C. 280, 286 (1974), *cert. denied*, 429 U.S. 1000 (1974).

[92] *Id.*

bad blood as an inference from "disagreement."[93] Despite the Tax Court's ambivalence on the weight to be given family hostility, it has always stood firm in holding that the attribution rules should at least be applied.[94]

VI. Waiver of Attribution: The Alternate Solution

This note has considered the effects of bad blood only on the dividend equivalency test of § 302(b)(1) up to this point. Congress did provide a relatively simple means of waving attribution rules where there is a complete redemption of interest. The method is outlined in § 302(c)(2).

Section 302(c)(2) waives the family attribution rules for the redeemed shareholder if (1) immediately after the distribution the distributee has no actual interest in the corporation other than interest as a creditor;[95] (2) the distributee does not acquire any such interest within ten years from the date of the distribution (unless by bequest or inheritance);[96] and (3) the distributee files an agreement to notify the Internal Revenue Service upon attaining any such interest.[97]

One may quickly perceive the potential applicability of this section to cases where family hostility motivates a redemption of stock. If family members wish to sever their business and personal relationships, complete redemption will achieve that goal without unfavorable tax consequences as long as the taxpayer meets the requirements and files the agreement. It is an apparently simple solution to the hostility question. The problem arises in cases such as *Haft* and *Squier* where the redeemed shareholder is not an individual family member but is a trust or an estate. The language of § 302(c)(2) refers specifically to § 318(a)(1) family attribution, and would not seem to apply to fatal attribution between beneficiaries and their corresponding trusts or estates. Thus, one might take the position that only an individual may waive family attribution.

In the case of trusts or estates, expanding the reading of § 302(c)(2)(A) to include attribution between entities and individuals is an alternative to recognizing bad blood in the dividend equivalency determination of § 302(b)(1). That alternative was embraced in the Fifth Circuit's decision in *Rickey v. United States*[98] and to some extent by the Tax Court's decision in *Estate of Crawford v. Commissioner*,[99] a case which preceded *Rickey*.

The reason for the complete termination of interest in *Rickey* was the death of the principal shareholder. The executor of his estate filed the agree-

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[93] *Id.* at 284.

[94] *See* Fehrs Finance Co. v. Comm'r, 58 T.C. 174 (1972), *aff'd*, 487 F.2d 184 (8th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974); Grabowski Trust v. Comm'r, 58 T.C. 650 (1972); Sawelson v. Comm'r, 61 T.C. 109 (1973).

[95] I.R.C. § 302(c)(2)(A)(i) (1976).

[96] I.R.C. § 302(c)(2)(A)(ii) (1976).

[97] I.R.C. § 302(c)(2)(A)(iii) (1976).

[98] 592 F.2d 1251 (5th Cir. 1979).

[99] 59 T.C. 830 (1973), *nonacq.*, 1974-2 C.B. 5. The Commissioner reasserted his rejection of *Estate of Crawford. See* Rev. Rul. 79-67, 1979-1 C.B. 128.

ment provided for in § 302(c)(2)(A)(iii) and contended that it was effective to waive the entity-beneficiary attribution rules. The Fifth Circuit agreed, expanding § 302(c)(2) to include Rickey's estate.

If the motivation for the complete termination of interest had been family hostility, one wonders if the court would have taken so liberal a position. Perhaps the exigencies of the facts of this case restrict application of its principles. The court, perhaps indicating impatience with such a wooden application of law, explained, "[w]e will not find that the decedent's death was a device to bleed out corporate profits at capital gains rates."[100]

Before *Rickey*, the Tax Court indicated its intention to avoid a "slavish" application of a statute's literal language where the application would lead to "absurd consequences."[101] In *Crawford* two corporations redeemed the shares of the estate of Walter Crawford which he had held as community property with Lillian, his wife. The redemption would have completely terminated the estate's interest in the corporation but for its constructive ownership of stock through Lillian's two sons who also owned shares. Both Lillian Crawford and the estate filed § 302(c)(2) waivers purporting to avoid attribution. Constructive stock ownership would have prevented them from benefiting from what would have otherwise been a § 302(b)(3) complete termination of interest. The Commissioner argued that no agreement the estate filed could prevent attribution to it. Foreshadowing his later argument in *Rickey*, he claimed the estate was an entity, and the only attribution waived by such an agreement was family attribution. The Commissioner also argued that Lillian Crawford could not file the agreement needed to waive attribution because she was not the actual "distributee" according to a liberal interpretation of the Code. Nevertheless, the Tax Court held that the waiver agreement filed by the estate effectively waived attribution to it.[102] The Tax Court, by reaching equity through alternate means, did not need to consider the taxpayer's argument that the redemption would qualify as a redemption under § 302(b)(1).[103]

VII. THE TAX COURT'S LATEST POSITION: *Metzger*

Metzger Trust v. Commissioner[104] stands out from the other cases in the area because, although family hostility was the motivating factor for the redemption, no hostility existed between any of the attributees. The hostility

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[100] *Rickey*, 592 F.2d at 1258. It is interesting to note here that certain portions of *Rickey* were overruled by the Tax Equity and Fiscal Responsibility Act of 1982. That Act permits family attribution to be waived by an entity and its beneficiaries. As the authors of the Conference Report point out: "The waiver rules would not be extended to waivers of attribution to and from entities and their beneficiaries . . . . The bill thus is intended to overrule *Rickey* . . . ." H.R. REP. No. 97-760, 97th Cong., 2d Sess. 545 (1982).

[101] Estate of Crawford, 59 T.C. at 836. *See also* International Trading Co. v. Comm'r, 57 T.C. 455, 461 (1971). ("[W]e do not believe that strict construction requires a slavish unreasoning adherence to the literal reading of the statute.").

[102] Estate of Crawford, 59 T.C. at 837.

[103] In Johnson Trust v. Comm'r, 71 T.C. 941 (1979), the Tax Court extended the same expansive courtesy to trusts.

[104] 76 TAX CT. REP. DEC. (P-H) ¶ 76.3.

was confined to siblings where no attribution takes place. The Tax Court, in this case, sets out its current position on the bad blood factor as it affects § 302(b)(1) dividend equivalency. It also takes a firm position on further expansion of § 302(c)(2) and, therefore, on whether taxpayer trusts can make beneficial use of waiver agreements in the face of a redemption motivated by bad blood, as well.

On the issue of dividend equivalency, the Tax Court relied mainly on what it considered to be a clear statutory mandate for the proposition that the attribution rules should apply to dividend equivalency determinations under §302(b)(1). "It is not the function of a Court to rewrite or amend a statute in the guise of construing it,"[105] and if it had so desired, "Congress might have added a greater family fight exception to the attribution rules than it did."[106]

While the court recognized a limited role for the bad blood factor in a § 302(b)(1) determination, the factor would become relevant only after the attribution rules were applied. However, even then, family hostility would not be considered if attribution left a shareholder with 100% ownership after the transaction. Following *Davis*, the court found such a redemption could never result in a meaningful reduction of shareholder interest, family hostility or not, because one of the facts to be considered in making this determination (of dividend equivalency) is the constructive stock ownership.[107] The court reasoned that permitting redemption from a sole shareholder to result in a meaningful reduction of interest "ignores the constructively owned stock . . . contrary to the statute, regulations, the legislative history and the rule of *Davis*."[108]

Although the court recognized its decision created a harsh result,[109] the fact that the trust was, after strict application of the attribution rules, the sole shareholder both before and after the redemption, controlled its conclusion that no meaningful reduction of interest occurred.

The taxpayer relied on *Rickey* for the proposition that the trust could waive the attribution rules by complying with the requirements of § 302(c)(2)(A)(ii) and (iii). But the Tax Court, placing high value on judicial restraint, would not rely on *Rickey* and its rejection of a "crabbed reading" of the Code.[110] It summarily distinguished the prior case on the fact that the redemption there was necessitated by the death of a shareholder.

The Tax Court did not speak with one voice in *Metzger*. Judge Tannenwald did not support the majority's having even considered the issue of family hostility as a mitigator of the attribution rules. He pointed out that no hostility existed between attributees. Jacob Metzger was trustee of the Metzger trust. The fatal attribution was from Jacob to the trust. As Judge Tannenwald

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[105] 76 TAX CT. REP. DEC. (P-H) ¶ 76.3, at 31.
[106] *Id.*
[107] *Id.* at 32.
[108] *Id.* at 33.
[109] *Id.* at 34.
[110] *See* Rickey, 592 F.2d at 1258.

points out, "it seems obvious that Jacob could not be hostile to himself."[111] Judge Tannenwald and the four other Tax Court judges who concurred with him also disagreed with how the majority limited recognition of family discord. It had restricted recognition of the factor to "cases in which the taxpayer's actual and constructive ownership after the redemption is less than his actual and constructive ownership before the redemption. . . ." Judge Tannenwald claimed that such a stance "paves a road for objectionably arbitrary results."[112] By his reckoning, when the legal fiction of attribution is refuted by family discord, the amount of the attribution is irrelevant. The family hostility issue remains unsettled.

VIII. Critical Analysis

Taxpayers have sought relief from the assumption that they would act in concert with related persons and entities when in reality they shared nothing but a common desire to sever all contact. They have attempted to expand the interpretation of the language of § 302(c)(2) so that relief could follow the recognition of their waiver agreements. Most recently the taxpayer has offered family hostility to avoid dividend treatment even when the hostility did not involve § 318 attributees. They have had varying success.

The three routes taxpayers have taken to seek relief from what they considered harsh treatment show that the family hostility question is broader than the existence of a bad blood exception to the attribution rules. The question includes how family hostility affects the whole of § 302: the application of the attribution rules, dividend equivalency determination apart from attribution, and the waiver rules in § 302(c)(2). Taxpayers have used all three approaches.

Disregarding the attribution rules altogether appears unjustified. Even though a position that the basis for the § 318 rules always accords with reality is untenable, the Code is clear on the matter and unequivocally states "section 318(a) shall apply in determining the ownership of stock for purposes of this section."[113]

The value of giving effect to the attribution rules' application in all circumstances is increased efficiency and predictability for the tax planner.[114] The burden of actually defining and measuring the level of harmony between related parties in every case may well be impossible, or at least unbearable.[115] On the other hand, most would agree that dealings between those related by blood are often not at arm's length.[116] The language of § 302(b)(1) does appear flex-

[111] *Id.* at 44.
[112] *Id.*
[113] I.R.C. § 302(c)(1) (1976).
[114] *See* Coyle v. United States, 415 F.2d 488, 490 (4th Cir. 1968).
[115] *See* Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project — American Bar Association Committee on Legislative Revision*, 14 Tax L. Rev. 1, 51 (1958). "[T]he burden on tax administration and tax planning would be almost intolerable if these assumptions were treated only as presumptions, with the final issue depending on the particular factual situation."
[116] *See, e.g.*, Ringel, Surrey, & Warren, *Attribution of Stock Ownership in the Internal Reve-*

ible enough to admit consideration of the effects of clearly discernable family hostility when that factor motivates a redemption of stock. If the hostility is at a level high enough to prompt withdrawal from a profitable enterprise in order to sever personal relationship, it is probably high enough to be readily confirmed.

The presence of § 302(b)(1) in the Code can quite possibly obviate any need to ignore the attribution rules when there is bad blood between attributees. Though the attribution rules still apply, having whatever effect they will on "constructive ownership" does not necessarily result in actual control. The test under § 302(b)(1) considers the extent of that actual control, and consequently, whether the redemption resulted in a meaningful reduction of interest.

The rationale of *Squier*[117] and *Haft*[118] remains valid, but that stance does not necessarily have to run afoul of the Court's holding in *Davis*.[119] *Davis* negated the relevancy of a valid corporate business purpose when determining whether a distribution is essentially equivalent to a dividend.[120] But when suggesting the irrelevance of the presence or absence of a tax avoidance motive, the Court still appeared to be thinking in terms of what is good for the business. To be sure, the withdrawal of one faction in a hostile family is likely to be good for the business. But it may be a relatively simple matter for the taxpayer, a shareholder in a closely held corporation, to show that no business purpose at all was relevant when he agreed to the redemption of his or another family member's stock. He may, instead, be able to show clearly that his sole motivation, and that of his family, was personal, neither business nor tax oriented at all, and the kind of motivation that would produce action even in the face of a tax penalty.

Though some commentators have been reluctant to recognize that Congress intended to give the liberal construction to § 302(b)(1) necessary to allow recognition of family hostility,[121] "the intended scope of [the section] as revealed by [the] legislative history is certainly not free from doubt."[122] Given congressional intent to avoid "unnecessarily restrictive" legislation,[123] one could just as confidently support the notion that a liberal reading is called for.

The flexibility of § 302(b)(1) should not be defeated simply because fortuitous circumstances and the effects of attribution result in an individual's being a 100% shareholder both before and after the redemption. Judge Tannen-

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nue Code, 72 HARV. L. REV. 209 (1958). The "rules of constructive ownership rest on certain assumptions which are readily supportable in the everyday conduct of affairs."

[117] Estate of Squier v. Comm'r, 35 T.C. 950 (1961), *acq. withdrawn and nonacq. substituted*, 1978-2 C.B. 5.

[118] Haft Trust v. Comm'r, 510 F.2d 43 (1st Cir. 1975).

[119] United States v. Davis, 397 U.S. 301 (1970).

[120] There is some potential support for reinstating the business purpose rule under I.R.C. § 302(b)(1). *See, e.g.*, Albers v. Comm'r, 414 U.S. 982, 988 (1973) (Powell, J., dissenting from denial of certiorari, joined by Douglas and Blackmun, JJ. The opinion protests the severity of *Davis*.).

[121] *See* BITTKER & EUSTICE, *supra* note 26, at ¶ 9.24.

[122] *Davis*, 397 U.S. at 311.

[123] *Supra* note 42.

wald's concurrence in *Metzger* exposes the "objectionably arbitrary results" that can result from maintaining that position.[124] As Judge Tannenwald suggests, "whether or not a third party owns a minimal amount of stock has nothing whatsoever to do with the issue."[125]

The third alternative for dealing with redemptions caused by family hostility, expanding the reading of § 302(c), seems to have no valid justification. A broad reading of the § 302(b)(1) language and its supporting legislative history achieves the desired goal. Arriving at the same destination by what amounts to judicial amendment of legislation is unsatisfactory. Although it is the function of a court to construe statutes, it is not its function to amend.[126] Congress provided an uncomplicated method of retiring the interests of shareholders in § 302(c)(2). The method is especially useful when bad blood causes complete termination of a family member's interest. Admittedly, it is difficult to believe Congress could have intended to make that method unavailable when the shares happen to be owned by an estate or trust, or the fatal attribution involves one of these entities. Nevertheless, one can find no provision in the statute to waive attribution between those entities. The Internal Revenue Code limits the waiver to attribution between family members. If Congress erred in the omission, it is Congress' responsibility to make the correction, not the responsibility of the courts. Until it does, a liberal reading of § 302(b)(1) is sufficient to handle the problem.[127]

Congress has indirectly recognized family hostility, division of interest, and communication breakdowns in other parts of the Internal Revenue Code. For example, the presumption that spouses are of one mind in reporting income in a joint tax return can be rebutted under § 6013(e). If one spouse establishes that in signing the joint tax return he or she did not know of an omission in the reported gross income, then after taking into account all the facts and circumstances, the Internal Revenue Service can relieve that spouse of liability.

Commonality of action between family members is also not assumed in the case of tax fraud. Section 6653(b) implies that in the case of tax fraud involving a joint return, the fraud must be established separately for each spouse.[128]

The Supreme Court expressed its willingness to review longstanding assumptions of commonality when, in *Trammel v. United States*,[129] it re-examined the rule which allowed a privilege against adverse spousal testimony.

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[124] *Metzger Trust*, 76 TAX CT. REP. DEC. (P-H) ¶ 76.3 to 37a.

[125] Metzger Trust, 76 T.C. 42, 84 (1981), appeal filed Aug. 14, 1981.

[126] *See* United States v. Calamaro, 354 U.S. 351, 357 (1957); Farmers Tractor & Equip. Co. v. United States, 224 F. Supp. 391, 394 (E.D. Ark. 1963).

[127] The obvious fourth, and perhaps best alternative, is legislative action to resolve the issue. See Brogan, *The Interaction Between Family Attribution Rules and Corporate Redemptions*, 31 CASE W. RES. L. REV. 304 (1981), for recommendations.

[128] In many instances courts have espoused a literal, non-yielding interpretation of the Code. See, e.g., McWilliams v. Comm'r, 331 U.S. 694 (1947), where the Court gave a strict interpretation to § 267(b), (c) which provides for constructive ownership of stock in the context of § 267 disallowances of deductions for losses, expenses, and interest from transactions between related shareholders.

[129] 445 U.S. 40 (1980).

The privilege was based on its role of fostering family harmony. But Chief Justice Burger took a more realistic view, noting that "[w]hen one spouse is willing to testify against the other in a criminal proceeding . . . there is probably little in the way of marital harmony for the privilege to preserve."[130] Rather than "frustrate justice" the Court chose to weigh reality heavier than assumption.[131]

IX. SUMMARY

This note has traced the history of cases in which taxpayers have offered bad blood as a factor to mitigate harsh effects sometimes attendant a literal, mechanical approach to sections 302 and 318 of the Internal Revenue Code. The better approach to the family hostility problem seems to be to continue to recognize the effects of the rules governing attribution of stock. But that recognition would be tempered with the realities of the factual setting. Section 302(b)(1) permits such a flexible approach. Of course, the best solution to the problem would come from legislative clarification of congressional intent; until that clarification appears, rights of judicial discretion must prevail.*

Joseph J. Miller

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[130] *Id.* at 52.

[131] *Id.*

* Two developments, occuring as this article went to print, make the recognition of family hostility as a mitigator of the sometimes harsh effects of the attribution rules in the context of stock redemptions less likely. First, the Tax Equity and Fiscal Responsibility Act of 1982, 1982 Fed. Taxes (P-H) ¶ 59,552, overruled Rickey v. United States, 592 F.2d 1251 (5th Cir. 1979). *See supra* note 100. The Act prohibited waivers by entities other than individuals through the addition of the following new subparagraph to I.R.C. § 302(a):

(C) SPECIAL RULE FOR WAIVERS BY ENTITIES.—

(i) IN GENERAL.—Subparagraph (A) shall not apply to a distribution to any entity unless—

(I) such entity and each related person meet the requirements of clauses (i), (ii), and (iii) of subparagraph (A), and

(II) each related person agrees to be jointly and severally liable for any deficiency (including interest and additions to tax) resulting from an acquisition described in clause (ii) of subparagraph (A).

In any case to which the preceding sentence applies, the second sentence of subparagraph (A) and subparagraph (B) (ii) shall be applied by substituting 'distributee or any related person' for 'distributee' each place it appears.

(ii) DEFINITIONS.—For purposes of this subparagraph—

(I) the term 'entity' means a partnership, estate, trust, or corporation; and

(II) the term 'related person' means any person to whom ownership of stock in the corporation is (at the time of the distribution) attributable under section 318(a)(1) if such stock is further attributable to the entity under section 318(a)(3).

Tax Equity and Fiscal Responsibility Act of 1982, 1982 FED. TAXES (P-H) ¶ 59,552.

Second, the Tax Court's decision in *Metzger* was affirmed by the Fifth Circuit Court of Appeals in Metzger Trust v. Commissioner, 693 F.2d 459 (1982). The court found the reasoning in Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975), unpersuasive and applied United States v. Davis, 397 U.S. 301 (1970), literally, holding that family hostility could not mitigate the stock attribution rules. The determination of the issue, the court opined, "is not a task measured by the chancellor's foot." 693 F.2d at 472. The court refused to look past what it considered to be the plain language of the law in order to "do equity." *Id.*

The first and fifth circuits disagree. The matter is now ripe for Supreme Court clarification.